IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF PUERTO RICO

IN RE:	CASE NO. 11-00336 (ESL)
FUGITIVE RECOVERY INVESTIGATIONS, INC.	CHAPTER 11
Debtor	

OPINION AND ORDER

There are two issues pending in this case. The first issue before the court is the United States Internal Revenue Service's (hereinafter referred to as the "IRS") request for retroactive annulment of the automatic stay regarding a setoff of $131,070.12 in funds which were owed to Debtor by the United States Department of Defense (hereinafter referred to as the "DOD") and were offset post-petition against Debtor's outstanding federal tax liabilities pursuant to the Federal Payment Levy Program, 26 U.S.C. §6331(h) (Docket Nos. 25, 49). The second issue before the court is the IRS' motion to dismiss the instant case for failure to file post-petition tax returns and pay post-petition taxes pursuant to 11 U.S.C. §1112(b)(4)(I) (Docket Nos. 39, 49). Debtor filed its opposition to the IRS' motion for retroactive annulment of the automatic stay and to the motion to dismiss pursuant to 11 U.S.C. §1112(b)(4)(I) (Docket No. 45). A hearing was held on both matters on April 8, 2011. For the reasons stated herein, this court grants the IRS' motion to dismiss the instant case. Consequently, the IRS' request for retroactive annulment of the automatic stay is moot.

Facts and Procedural Background

Fugitive Recovery Investigations, Inc. filed a bankruptcy petition under Chapter 11 of the Bankruptcy Code on January 20, 2011. The Debtor included the IRS in its "List of Creditors Holding 20 Largest Unsecured Claims" in the amounts of $499,807.32 and $29,913.79. (Docket No. 1). Debtor also listed the Puerto Rico Department of the Treasury ("PR Treasury") in its "List if Creditors Holding 20 Largest Unsecured Claims" in the amount of $585,033.86 for payroll taxes (Docket No. 1). Debtor also listed in its Schedule E, Creditors Holding Unsecured Priority Claims, the IRS' claim for withholding of payroll taxes (including FUTA) in the amount of $493,237.15. Debtor listed in

its Schedule E, Creditors Holding Unsecured Priority Claims, the PR Treasury's claim for payroll taxes in the amount of $585,481.98 (Docket No. 18). On February 9, 2011, the IRS filed proof of claim #2-1 in the amount of $990,601.82, of which it claims $437,552.87 to be secured, $126,705.84 to be unsecured, and the remainder $426,343.11 as an unsecured priority tax claim under 11 U.S.C. §507(a)(8). On June 23, 2011, the PR Treasury filed proof of claim #42-1 in the amount of $802,133.85, of which it claims $612,251.32 as an unsecured priority tax claim under 11 U.S.C. §507(a)(8), and the remainder $189,882.53 as unsecured. Subsequently, on April 4, 2011, the IRS filed an amended proof of claim #4-1 in the amount of $973,183.42, of which it claims $437,552.87 to be secured, $135,263.90 to be unsecured, and the remainder $400,366.65 as an unsecured priority tax claim under 11 U.S.C. §507(a)(8).

On March 7, 2011, the IRS filed a motion for relief from the automatic stay, *nunc pro tunc*, requesting retroactive relief from the automatic stay pursuant to 11 U.S.C. §362(d)(1) as to $131,070.12 in funds which were owed to the Debtor under contracts with the DOD, but which were setoff pursuant to the Federal Payment Levy Program, 26 U.S.C. §6331(h) and applied against Debtor's outstanding federal tax liabilities (Docket No. 25). In said motion the IRS provides the following background information: (i) during the period of December 1, 2010 through December 31, 2010, Debtor performed certain services for the DOD under various DOD contracts; (ii) Debtor on or around January 3, 2011 submitted to the DOD two (2) invoices numbered 10673 and 10674 in the total amount of $133,070.12 for the services rendered during the month of December (Docket No. 25, Exhibit I- Invoices); (iii) on or around February 2, 2011, the DOD processed the invoices for payment but since Debtor had outstanding federal tax liabilities, the DOD through the Federal Payment Levy Program, transferred the payment corresponding to Debtor's invoices to the IRS; and (iv) on or around February 3, 2011, after someone from Debtor's accounting office contacted the IRS, the same took steps to ensure that the Debtor's federal tax liabilities would not trigger any further setoffs through the Federal Payment Levy Program (Docket No. 25). The IRS concedes that the levy of funds owed under the referenced invoices violated the automatic stay, but alleges federal law "permits bankruptcy courts to lift the automatic stay retroactively and thereby validate actions that would otherwise be void." In re Soares, 107 F. 3d 969, 976 (1st Cir. 1997). The IRS argues that this

court should afford retroactive relief of the automatic stay based on the following: (i) Debtor's bad faith which consists of its failure to file post-petition tax returns and pay post-petition taxes pursuant to 11 U.S.C. §1112(b)(4)(I); and (ii) "...under federal law, the United States was entitled to setoff the funds that would otherwise have been paid to the Debtor, and given the Debtor's history of unpaid federal taxes, and its continuing failure to comply with federal tax laws, the United States' should be granted retroactive relief from the automatic stay." (Docket No. 25). The IRS also argues that the funds in controversy were subject to a valid right of setoff based on the following reasons: (1) the pre-petition claim of the United States and the contract payment for pre-petition services are mutual obligations; (2) payments on government contracts may be setoff against the payee's federal tax obligations pursuant to 26 U.S.C. §6331(h); and (3) the three (3) requirements for setoff under 11 U.S.C. §553 are satisfied, namely; (i) the debt owed by the United States to the Debtor for the services performed in December 2010 and invoiced on January 3, 2011, under the government contracts was incurred upon the completion of the services which occurred before the filing of Debtor's bankruptcy petition; (ii) the Debtor has federal tax liabilities for multiple tax periods which are pre-petition (Docket No. 25, Exhibit 2, IRS' Proof of Claim); and (iii) the mutuality test is satisfied because the United States is a single government creditor for purposes of Section 553 and may exercise setoff lines across agency lines, thus the DOD and the IRS are both parts of the United States government and are mutual (Docket No. 25).

Subsequently, on March 22, 2011, the IRS filed a motion to dismiss pursuant to 11 U.S.C. §1112(b)(4)(I) for Debtor's failure to file both pre-petition and post-petition tax returns and to make post-petition federal employment tax returns which constitutes bad faith and warrants dismissal (Docket No. 39). The IRS also argues that even though Debtor's failure to file pre-petition tax returns is not included amongst the examples of cause established by 11 U.S.C. §1112(b)(4), the list is not exhaustive. The IRS claims that Debtor has not filed its unemployment tax returns (Form 940) for the years 2009 and 2010, nor its quarterly employment tax returns (Form 941) for the period ending on December 31, 2010, nor made any of its payments on its employment tax liabilities for the first quarter of 2011 (Docket No. 39, Declaration of Bankruptcy Specialist Daisy Montañez). On March 28, 2011, the Debtor filed its Opposition to the United States' Motion for Relief from the Automatic

Stay, *Nunc Pro Tunc*, and Opposition to the United States' Motion to Dismiss (Docket No. 45). Debtor's opposition to both motions are based on rebutting the IRS' allegation of its bad faith by arguing: (i) Debtor has been struggling with cash flow problems since the IRS first offset on November 2010, which resulted in a turnover of employees that hindered Debtor's timely compliance of its duties, which was aggravated by the IRS' illegal levy of $131,070.12 from Debtor; (ii) Debtor's non-compliance with its filing duties with the IRS were directly caused by the IRS' actions pre and post-petition; (iii) Debtor has recruited a new comptroller who has quickly resolved the pending issues with the IRS and has filed the pending unemployment tax returns for 2009 and 2010, and the quarterly employment tax return for the period ending December 31, 2010 (Docket No. 45, Exhibits A & B); and (iv) Debtor was unable to make the payment of its employment tax for the first quarter of 2011 because of the illegal levy of funds by the IRS on February 3, 2011 to offset federal tax liabilities owed by Debtor. The Debtor argues that the IRS is not entitled to the retroactive relief from the automatic stay because it has failed to present sufficient evidence of "extreme circumstances" that are warranted for this discretionary relief to be afforded to the movant. Debtor argues that the Debtor's alleged bad faith is based solely on its failure to file three (3) tax returns (which have been filed) and the failure to pay post-petition taxes which could not be paid due to the IRS' illegal levy of funds. Moreover, Debtor alleges that the post-petition offset performed by the IRS was illegal because it was made against a pre-petition liability.

On April 4, 2011, the United States filed its reply to Debtor's Response to Motion for Relief From Stay, *Nunc Pro Tunc,* and Motion to Dismiss by which it presented the following arguments: (i) even though the payment of the United States debt was made post-petition, the same was due and owing prior to Debtor's bankruptcy petition, meaning that the debt arose prior to the commencement of the case; (ii) the fact that the United States has not paid over the funds while it obtains relief from the automatic stay should not serve as grounds for denying the United States' motion, nor is it a sign of bad faith; (iii) Debtor fails to address the fact that its 2009 unemployment tax return was due approximately a year before the debtor filed for bankruptcy and was filed after the United States filed its motion to dismiss; (iv) Debtor's delay in filing its 2009 unemployment tax return is evidence of Debtor's bad faith and grounds for the court to grant the IRS retroactive relief from the automatic

stay; (v) the February setoff did not occur until after the tax returns at issue were due, so the debtor cannot shift the blame to the IRS for its delay in filing the tax returns; (vi) Mr. Setien's (president of Debtor) declaration lacks credibility since he alleged that Debtor was able to hire a new comptroller, Mr. Luis Crespo, as recently as March 7, 2011 but the employment tax return for the period ended December 31, 2010, attached to Debtor's response was signed on February 28, 2011; (vii) Debtor's history of tax non-compliance since the year 2007 to the present evinces its bad faith; (viii) the only remaining issue regarding the IRS' motion to dismiss is the Debtor's failure to pay post-petition taxes; (ix) regarding the February setoff, the United States Supreme Court in Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 21 (1995) recognized that creditors should be allowed to hold on to funds subject to setoff while it requests relief from the automatic stay; (x) it would be absurd to require the United States to pay the Debtor due to the substantial amounts owed by the same to the IRS; and (xi) if the Debtor pays its employees, it is required to also pay employment taxes (Docket No. 46). Subsequently, on April 7, 2011, the Debtor filed a Supplement to Opposition to United States' Motion for Relief from Automatic Stay, *Nunc Pro Tunc*, and Opposition to United States' Motion to Dismiss informing the court of a letter dated March 25, 2011, sent to Debtor by the U.S. Department of Labor threatening to perform another illegal offset (Docket No. 47, Exhibit A). On April 8, 2011, a hearing was held in which the court took under advisement the IRS' motion for annulment of stay with retroactive effect and the motion to dismiss (Docket No. 49). On April 11, 2011, Debtor filed an objection to the IRS' amended proof of claim contesting the secured nature of the claim and the amount of said claim ($437,552.87) (Docket No, 50). The Debtor alleges that it owes the IRS the amount of $206,948.23 as a priority claim inclusive of interest and the penalties which amount to $82,955.63 for a total amount of $289,903.86 (Docket No. 50). On May 11, 2011, the IRS filed its response to Debtor's objection of the IRS' proof of claim (Docket No. 55). A pretrial conference has been scheduled for August 19, 2011, regarding Debtor's objection to the IRS' proof of claim (Docket No. 56).

The contested matters came before the court on April 8, 2011 for an actual hearing. The court took under advisement two issues; namely (1) the IRS' request for retroactive annulment of the automatic stay pursuant to 11 U.S.C. §362(d) regarding the setoff of $131,070.12 in funds which

were owed to Debtor by the DOD and were offset post-petition against Debtor's outstanding federal tax liabilities pursuant to the Federal Payment Levy Program, 26 U.S.C. §6331(h) and (2) the IRS' motion to dismiss pursuant to 11 U.S.C. §1112(b)(4)(I) which is based on Debtor's failure to pay post-petition taxes and whether Debtor's tax non-compliance constitutes bad faith. The court will only address the second issue as the same is dispositive of the case.

Applicable Law & Analysis

Cause for Conversion or Dismissal pursuant 11 U.S.C. §1112(b)

Section 1112(b) of the Bankruptcy Code mandates the bankruptcy court after notice and a hearing to convert or dismiss a chapter 11 case, whichever is in the best interests of creditors and the estate, if the movant establishes cause and the case is devoid of unusual circumstances pursuant to 11 U.S.C. §1112(b)(1) and (b)(2). 11 U.S.C. §1112(b). Thus, limiting the bankruptcy court's discretion to dismiss or convert a chapter 11 case for "cause." See Gilroy v. Ameriquest Mortg. Co. (In re Gilroy), 2008 Bankr. Lexis 3968 (B.A.P. 1st Cir. 2008); AmeriCERT, Inc. v. Straight Through Processing, Inc. (In re AmeriCERT, Inc.), 360 B.R. 398, 401(Bankr. D. N.H. 2007)("Prior to its amendment, the statute provided that a court 'may' dismiss the case upon finding cause, but amended section 1112(b) provides that a court 'shall' dismiss if cause is found, absent unusual circumstances."). The initial burden is on the movant to argue and present evidence by a preponderance of the evidence standard to prove its position that there is cause for either conversion or dismissal of the chapter 11 case, whichever is in the best interests of creditors and the estate. See Alan N. Resnick & Henry J. Sommer, 7 Collier on Bankruptcy ¶1112.04[4] (16th ed. 2011). "Thus, until the movant carries this burden, the statutory direction that the court 'shall convert the case to a case under chapter 7 or dismiss the case' is not operative." Id. Once the movant establishes "cause", the burden shifts to the debtor to demonstrate by evidence the "unusual circumstances" that establish that dismissal or conversion to Chapter 7 is not in the best interests of the creditors and the estate. See Alan N. Resnick & Henry J. Sommer, 7 Collier on Bankruptcy ¶1112.05[1] (16th ed. 2011). The bankruptcy court retains discretion in determining whether unusual circumstances exist and whether conversion or dismissal is in the best interest of creditors and the estate. See Id; Gilroy v. Ameriquest Mortg. Co. (In re Gilroy), 2008 Bankr. Lexis 3968 (B.A.P. 1st Cir. 2008). A determination of unusual

circumstances is fact intensive and contemplates facts that are not common to chapter 11 cases. See Alan N. Resnick & Henry J. Sommer, 7 Collier on Bankruptcy ¶1112.05[1] (16th ed. 2011). If the Chapter 11 case is devoid of "unusual circumstances" then, the bankruptcy court must apply the Section 1112(b)(2)[1] analysis to determine whether the Chapter 11 case is dismissed or converted. The objecting party must establish all of the factual elements stated in subparagraphs (A) and (B) of section 1112(b)(2). See Alan N. Resnick & Henry J. Sommer, 7 Collier on Bankruptcy ¶1112.05[1] (16th ed. 2011). Thus, the bankruptcy court must not convert or dismiss a case if: "(1) there is a reasonable likelihood that a plan will be confirmed within a reasonable time; (2) the 'cause' for dismissal or conversion is something other than a continuing loss or diminution of the estate coupled with a lack of reasonable likelihood of rehabilitation; and (3) there is a reasonable justification or excuse for a debtor's act or omission and the act or omission will be cured within a reasonable time." In re Orbit Petroleum, Inc. 395 B.R. 145, 148 (Bankr. D. N.M. 2008) aff'd, 421 B.R. 602 (B.A.P. 10th Cir. 2009).

Section 1112(b)(4) of the Bankruptcy Code fails to define what the term "cause" means but provides a list of circumstances which constitute "cause" for conversion or dismissal. This list of causes is nonexhaustive, thus a case may be converted or dismissed for other causes. See AmeriCERT, Inc. v. Straight Through Processing, Inc. (In re AmeriCERT, Inc.), 360 B.R. 398, 401

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[1]Section 1112(b)(2) provides:

> "[t]he court may not convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter if the court finds and specifically identifies unusual circumstances establishing that converting or dismissing the case is not in the best interests of creditors and the estate, and the debtor or any other party in interest establishes that–
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> (A) there is a reasonable likelihood that a plan will be confirmed within the timeframes established in sections 1121(e) and 1129(e) of this title, or if such sections do not apply, within a reasonable period of time; and
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> (B) the grounds for converting or dismissing the case include an act or omission of the debtor other than under paragraph (4)(A)--
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> (i) for which there exists a reasonable justification for the act or omission; and
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> (ii) that will be cured within a reasonable period of time fixed by the court." 11 U.S.C. §1112(b)(2).

(Bankr. D. N.H. 2007).

Section 1112(b)(4)(I) specifically establishes that cause to dismiss or convert a chapter 11 case includes, "failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief." 11 U.S.C. §1112(b)(4)(I). In the instant case, it is an uncontested fact that the Debtor tardily filed the Employer's Quarterly Federal Tax Return for the fourth quarter of 2010 (Form 941-PR) and the Employer's Annual Federal Unemployment (FUTA) Tax Return for the years 2009 and 2010 (Form 940) (all of the aforementioned tax returns were received by the IRS on March 25, 2011 as indicated by the IRS stamp) and has failed to pay to the IRS the FICA and FUTA taxes owed in accordance with these tax returns. The due date for filing Form 940 is on January 31st and the due date for filing Form 941-PR is the last day of the month that follows the end of the quarter, thus for the last quarter of 2010, Form 941-PR was due on January 31, 2011. However, the employment taxes (Form 941) must be deposited monthly, if the total taxes on Form 941 for the 4 quarters in the taxpayer's lookback period were $50,000.00 or less and semi-weekly if the total taxes were over $50,000. These deposits must be made by the 15th day of the following month if you are a monthly depositor. See IRS Publication 15: Employer's Tax Guide, pgs. 20-21 (2011); Publicación 179: Guía Contributiva Federal para Patronos Puertorriqueños; pgs. 12-14.

The court is troubled by the fact that the Debtor, as an employer, has failed to comply with its statutory duty to withhold social security and Medicare taxes (6.2% for social security, 1.45% for Medicare for the year 2010 and 4.2% for social security and 1.45% for Medicare for the year 2011) from its employees' wages and remit the same to the IRS (the employer tax rate for social security remains unchanged at 6.2%), in addition to the employer's contribution of social security and medicare taxes. See Id. Publication 15: Employer's Tax Guide, pg. 19; Publicación 179: Guía Contributiva Federal para Patronos Puertorriqueños; pgs. 10-11. Thus, Debtor's allegation that it was unable to make the payment of its employment tax for the first quarter of 2011 due to the illegal levy of funds by the IRS on February 3, 2011 is unfounded, given that Debtor had the obligation to withhold and remit these funds to the IRS on November 15th, December 15th and January 15th if it was a monthly depositor. The court notes that according to the declaration of bankruptcy specialist, Daisy Montañez, the Debtor is a semi-weekly depositor which means that the Debtor must deposit these

taxes more frequently (Docket No. 39, Exhibit). Moreover, the Debtor did not even deposit with the IRS the employees' portion regarding the social security and Medicare taxes. The court further notes that Debtor in its Schedule E- Creditors Holding Unsecured Priority Claims included the Puerto Rico Treasury Department having a claim in the amount of $585,481.98 for "withheld payroll taxes." The Puerto Rico Treasury Department's proof of claim #42-1 in the amount of $802,133.85 of which $198,355.24 is allocated to corporate income taxes and the rest of the tax liability is allocated to employment taxes withheld by Debtor which constitute state income taxes that Debtor withheld from its employees (tax years 2006-2009) and the 7% tax on withholdings for professional services (tax years 2004-2008). Therefore, it is clear that the Debtor has a history of withholding taxes from its employees and not remitting a timely payment to the IRS.

In the instant case, this court finds that the Debtor not only failed to pay its post-petition portion of the federal employment and unemployment taxes but also failed in its duty to remit the employees' portion of the social security and medicare taxes to the IRS. This court concludes that Debtor not only failed to pay post-petition employment (FICA) and unemployment taxes, but that its conduct with respect to employment taxes is a serious offense, as the Debtor failed to meet its obligations towards its employees in remitting their portion of the social security and medicare taxes to the IRS. Moreover, Debtor's allegation that, "[a]s to the payment of its employment tax for the first quarter of 2011, Debtor could not make said payments because of the illegal action of the IRS in offsetting $131,070.12 on February 3, 2011" (Docket No. 45, pg. 3) fails to explain why it failed to remit the employees' portion of the employment taxes which Debtor has the obligation to withhold and remit on a monthly basis or semi-weekly. Thus, this court concludes that there is cause pursuant to Section 1112(b)(4)(I) to dismiss the instant case.

The next phase of the analysis the court must engage in is whether the Debtor has demonstrated that there are "unusual circumstances" that establish that the dismissal or conversion is not in the best interests of the creditors and the estate. The court finds that the Debtor has not alleged "unusual circumstances" in the instant case. The court also concludes that the Debtor has not addressed the requirements under Section 1112(b)(2)(A) and (B) and thus has not established all of the factual elements in conformity with this section. The Debtor has failed to allege, and much less

meet its burden, that there are unusual circumstances showing that conversion or dismissal is not in the best interests of the estate and creditors. Lastly, this court concludes that the dismissal of the instant case moots the IRS' request for retroactive annulment of the automatic stay.

Conclusion

In view of the foregoing, the court finds that there is cause to dismiss this case pursuant to 11 U.S.C. §1112(b)(4)(I); and there being no unusual circumstances under 11 U.S.C. §1112(b)(2)(A) and (B), the case is hereby dismissed.

SO ORDERED.

In San Juan, Puerto Rico, this 13th day of July 2011.

Enrique S. Lamoutte
United States Bankruptcy Court